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April 15, 2004

Memorandum

To: Honorable John Morgan, Comptroller of the Treasury
Honorable David Goetz, Commissioner of Finance and Administration
Honorable Dale Sims, Treasurer
Honorable Riley Darnell, Secretary of State

From: Kevin Krushenski, Legislative Research Analyst
Bintou Njie, Legislative Research Analyst

Date: 4/15/2004

Re: Economic Report to the Governor

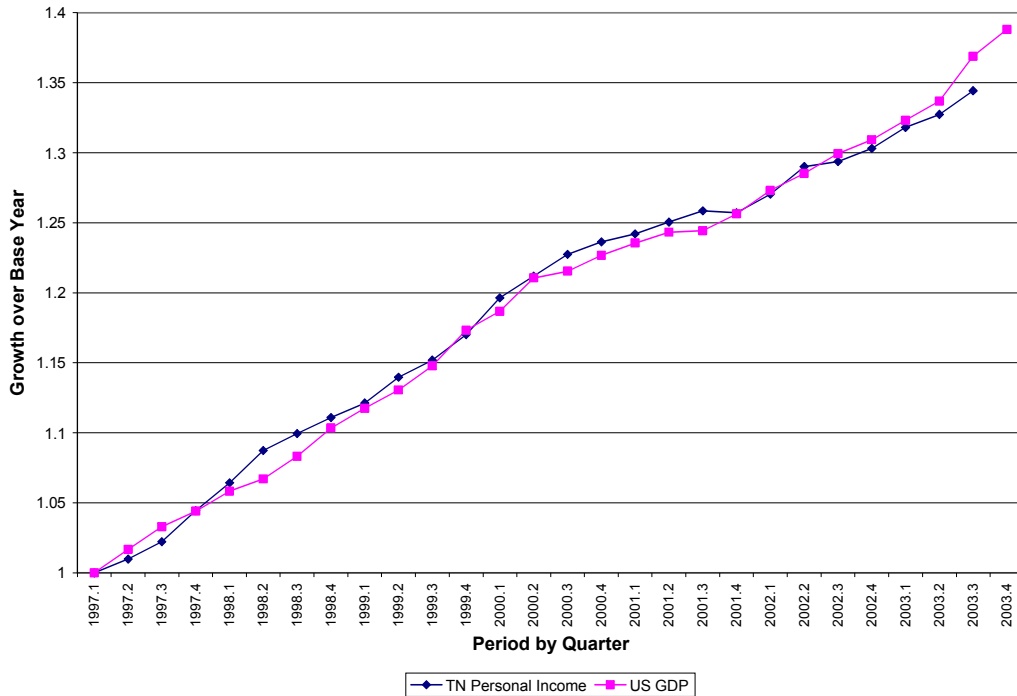
As required by TCA §9-4-5202, the State Funding Board (the Board) shall secure estimates of economic growth from the Tennessee econometric model published by The University of Tennessee's Center for Business and Economic Research (CBER) in its annual *Economic Report to the Governor* each year. The Report provides an overview of the current estimates of economic growth statistics, such as nominal personal income growth and employment growth. TCA §9-4-5202 also prescribes the Board to comment on the "reasonableness" of CBER's estimate of nominal personal income growth in Tennessee. The Comptroller's Office of Research assists the Board by evaluating current economic conditions and trends via outside forecasts.

Overall Conclusion: Based upon a review of various economic forecasts and other trends in the world economy, CBER's projections of nominal personal income growth for 2004 appear reasonable.

Forecast Comparisons

Historically, growth in Tennessee personal income has closely followed growth in United States gross domestic product (GDP). Exhibit 1 shows the relationship between relative growth in Tennessee personal income as it compares to the relative growth in U.S. GDP.

Exhibit 1: Relative Growth of Selected Economic Indicators



Source: United State Bureau of Economic Analysis, www.bea.gov, accessed 4/13/04

Because the relationship between the indicators is very close, for the purposes of this commentary we will compare the GDP estimates produced by CBER with the estimates produced by other economic forecasting agencies.

Many economists believe the United States' economy began to strengthen at the end of 2003 and is expected to continue its forward progress for 2004. As Exhibit 2 shows, on Average, economists forecast 4.6 percent real GDP growth for the U.S., which is similar to CBER's forecast of 4.7 percent. A more pronounced year over year growth is expected during the first two quarters of 2004.¹ This will largely be fueled by low interest rates, consumer spending, the competitive advantage of a lower value dollar, and anticipated job growth in many sectors.² These economic occurrences and other possible macroeconomic contributions will be discussed later in the commentary.

Exhibit 2: Forecast Comparison: 2004 Real GDP Growth		
Agency	Rate	Forecast Date
Fannie Mae	4.5%	Mar-04
Wachovia	4.8%	Mar-04
Philadelphia FBR	4.6%	Feb-04
Northern Trust	4.4%	Mar-04
CBER	4.7%	Dec-03
Forecast Average		4.6%
Source: Fannie Mae, Wachovia, Federal Reserve Bank of Philadelphia, and Northern Trust		

Potential Macroeconomic Influences

Job Growth and Unemployment

One of the major concerns of the economic recovery since the most recent recession has been the loss of jobs and increasing unemployment. Many economists are projecting job gains in many sectors. In the most recent release of the employment data, non-farm payroll employment increased by 308,000 in March, but the unemployment rate remained unchanged at 5.7 percent.³ While this impressive pace is not expected to be a trend, sources anticipate that the United States should expect job growth to continue throughout the year. In March of 2004, 78 percent of CEOs participating in the Business Roundtable's CEO Economic Outlook Survey projected that employment will either remain the same or increase in the next six months.



Source: "Fewer Job Cuts Announced" CNN Money, April 6, 2004

Of course, certain macroeconomic changes may impact this projected job growth.

¹ "Survey of Professional Forecasters", The Federal Reserve Bank of Philadelphia, Economic Research, February 23, 2004

² Nariman Behravesh, Chief Economist, "Top Ten Economic Predictions for 2004," Global Insight, March 2004

³ U.S. Department of Labor, Bureau of Labor Statistics, "Employment Situation Summary," April 2, 2004

Outsourcing

Outsourcing of jobs is a reality that many Americans continue to face. Not including March of 2004, the United States has seen job losses or slow job growth since February of 2003. The manufacturing industry, especially non-durable goods, has arguably been hit the hardest by outsourcing. Economists disagree as to the effects of outsourcing, with some believing it hurts the U.S. and others believing it helps. A recent study by Global Insights on outsourcing of Information Technology (IT) personnel concluded:

- Global sourcing of computer software and services, while displacing some IT workers actually benefits the U.S. economy and increases the number of U.S. jobs.
- Benefits include job creation, higher real wages, higher real GDP growth, contained inflation and expanded exports resulting in increased economic activity.
- U.S. spending for offshore outsourcing of computer software and services is expected to grow at a compound annual rate of almost 26%, increasing from approximately \$10 billion in 2003 to \$31 billion in 2008.⁴

Many, however, would agree that most of the lost jobs in the manufacturing industry will probably not return if current policies remain unchanged.

International Influence

The world should see varying levels of economic growth this year. The International Monetary Fund foresees the most growth for advanced economies occurring in the United States and United Kingdom with lagging growth for Japan and the European area.⁵ Exhibit 4 shows that projected GDP growth for many developing countries should outpace most others.

Exhibit 4: International Economic Growth Projections

	2001	2002	Current Projections		Difference from April 2003 Projections ¹	
			2003	2004	2003	2004
World output	2.4	3.0	3.2	4.1	—	—
Advanced economies	1.0	1.8	1.8	2.9	-0.1	—
United States	0.3	2.4	2.6	3.9	0.4	0.3
Euro area	1.5	0.9	0.5	1.9	-0.6	-0.4
Germany	0.8	0.2	—	1.5	-0.5	-0.4
France	2.1	1.2	0.5	2.0	-0.7	-0.4
Italy	1.8	0.4	0.4	1.7	-0.7	-0.6
Japan	0.4	0.2	2.0	1.4	1.2	0.4
United Kingdom	2.1	1.9	1.7	2.4	-0.3	-0.1
Canada	1.9	3.3	1.9	3.0	-0.9	-0.2
Other advanced economies	1.6	2.7	1.7	3.0	-0.8	-0.2
Newly industrialized Asian economies	0.8	4.8	2.3	4.2	-1.8	-0.3
Developing countries	4.1	4.6	5.0	5.6	—	-0.2
Africa	3.7	3.1	3.7	4.8	-0.2	-0.4
Sub-Sahara	3.5	3.0	3.1	5.0	-0.7	-0.4
Developing Asia	5.8	6.4	6.4	6.5	0.1	—
China	7.5	8.0	7.5	7.5	—	—
India	4.2	4.7	5.6	5.9	0.5	—
ASEAN-4 ²	2.9	4.3	4.1	4.4	0.2	0.1
Middle East and Turkey ³	2.0	4.8	5.1	4.6	—	-0.3
Western Hemisphere	0.7	-0.1	1.1	3.6	-0.4	-0.6
Brazil	1.4	1.5	1.5	3.0	-1.3	-0.5

Source: International Monetary Fund, World Economic Outlook, September 2003

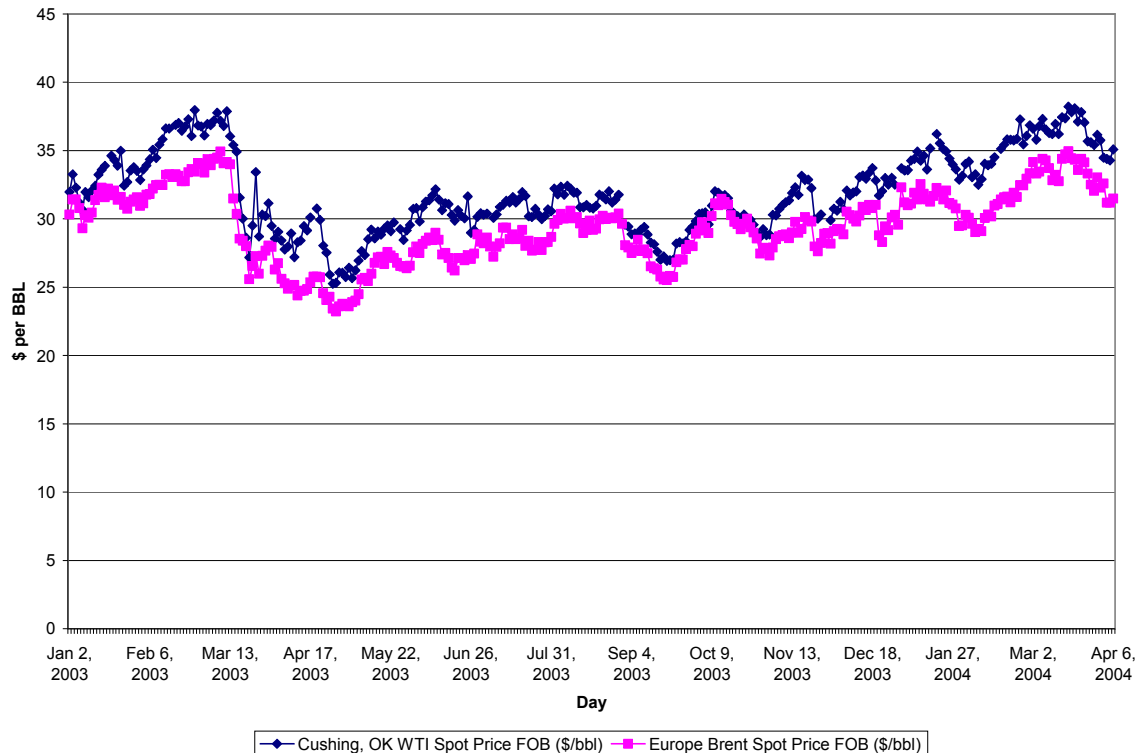
⁴ Global Insights, Executive Summary- "The Comprehensive Impact of Offshore IT Software and Services Outsourcing on the U.S. Economy and the IT Industry," March 2004

⁵ International Monetary Fund, *World Economic Outlook*, September 2003

Oil Prices

The cost of oil is a major contributor to the cost of business. Oil prices continued to be affected by supply and demand issues and other international political matters. With the instability of post-war Iraq and other concerns regarding the Middle East and our other major oil producing countries (i.e. Nigeria and Venezuela), oil prices have risen. As Exhibit 5 shows, oil prices trended upward since the beginning of the summer of 2003 despite many projections that they would remain low or even drop further.

Exhibit 5: Daily International Oil Prices from Jan 2003 to April 2004



Source: U.S. Department of Energy, Energy Information Administration, Daily Spot Prices

The prices of gasoline by the gallon followed the increase of oil by the barrel. In recent weeks, the American Automobile Administration (AAA) has released survey information detailing that gasoline prices are seeing record highs.⁶ The Energy Information Administration (EIA) recently reported that summer gasoline prices are expected to average a record high of \$1.76 per gallon.⁷ Oil and gas prices shocks such as these have a direct effect on economic growth since rising oil prices mean reduced supply of oil which is an important input to business production.⁸ Any additional shocks to oil and gas prices could severely hamper economic and business growth.

⁶ "Another Day, Another Record Gas Price," USA Today – Money, March 23, 2004

⁷ U.S. Department of Energy, Energy Information Administration, "Tight Markets to Keep Summer Gasoline Prices High," April 8, 2004

⁸ Stephen P.A. Brown, et al, "Business Cycles: The Role of Energy Prices," Working Paper 03-04, Federal Reserve Bank of Dallas – Research Department, 2003, p. 2

Business Investment

Business investment is expected to pick up this year through increasing payrolls and capital spending. Interest rates are still at all-time lows, but with the economy on the upswing and deflation fears beginning to subside, the Fed is expected to raise interest rates this year. This should encourage wary businesses to act sooner rather than later and may contribute to the larger GDP growth in the first few quarters. Combined with the low value of the dollar and anticipated tax refunds, sales should increase and may encourage businesses to invest more into production. In the recently released consumer spending indicator, retail sales rose 1.8 percent in March, which bettered expectations.⁹ One of the major disadvantages of a weak dollar however, is that it leads to higher domestic inflation due in part to the lack of price competition from the now higher priced foreign goods.¹⁰ This may lead to action by the Federal Reserve Board to raise interest rates.

Summary

With employment, business investment and consumer spending all poised to continue making progress, the economy should enjoy relatively strong growth when compared to previous years. The underlying fears of the uncertainty in the Middle East and Iraq, foreign and domestic terrorism concerns, rapidly rising oil prices, along with the outsourcing of many U.S. jobs to other countries, may impede potential growth, but most economists would not project those impediments to be too severe. Based upon this research, the CBER estimates of 5.0 percent growth in nominal personal income for 2004 appear reasonable.

⁹ "Shopping Spree," <http://money.cnn.com>, April 13, 2004

¹⁰ Ronald A. Wirtz, Senior Writer, "Exchange Roller Coasters," Federal Reserve Bank of Minneapolis, December 2002, p. 4